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THE DEVELOPMENT OF COMMONWEALTH - STATE FINANCIAL ARRANGEMENTS IN AUSTRALIA

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This article reviews the development of Commonwealth-State financial arrangements in Australia, with special reference to the assignment of powers, taxation, grants arrangements, and public sector borrowing. References to the Australian States should be taken to include the Northern Territory, which has been self-governing since 1978. The Australian Capital Territory continues to be administered by the Commonwealth (Federal) Government.

THE ASSIGNMENT OF TAXING, BORROWING AND EXPENDITURE POWERS

The Commonwealth Constitution gives the Commonwealth and the States concurrent powers over all forms of taxation other than customs and excise duties, which are exclusive to the Commonwealth. Except for rents or royalties from offshore minerals, which the Commonwealth has agreed to share with adjoining States, the States control natural resource revenues resulting from the reservation of mineral rights for the Crown. States are also able to derive revenues from resource development indirectly, for example through charges for rail or electricity services. Although generally precluded from granting any bounties on the production or export of goods, this restriction does not apply to metals, and States are able to subsidise mineral production indirectly through the prices they charge for services. For its part, the Commonwealth has been able to control some mining operations indirectly by refusing to grant export licences; it also has the power to impose export taxes.

Commonwealth and State governments originally had concurrent powers with respect to borrowing and the public debt. However, following a financial Agreement between the Commonwealth and States in 1927, the Constitution was amended to establish the Australian Loan Council with the power to control the amounts, terms and conditions of most Commonwealth and State borrowing in Australia. For reasons discussed below, the Commonwealth has exercised a large measure of control over the Loan Council and hence over public sector borrowing.

Under the Commonwealth Constitution, the Commonwealth Government has the responsibility for those functions of government which are international in character (such as defence and foreign affairs), involve national matters (such as citizenship and currency) or have interstate ramifications (such as activities extending beyond the limits of individual States). The States have the formal responsibility for most aspects of law and order, social services, local government,

community and economic services, and resource development. However, in many of these areas responsibility is shared between the Commonwealth and the States depending on whether the activities have international or interstate dimensions or are confined within individual States. Thus international and interstate trade and commerce, conciliation and arbitration in relation to industrial disputes extending beyond the limits of any one State, and banking other than State banking within a State are the subject of Commonwealth powers while similar activities within States are controlled by State laws. In addition, the Commonwealth has used its financial powers, especially a general grants power whereby it can provide financial assistance to States on such terms and conditions as it sees fit, to involve itself in various ways in functions such as education, health and transport which are formally State responsibilities. Both in this way and as a result of the interdependence of the two levels of government in relation to many areas of decision making, there is a significant degree of sharing of responsibility for social and economic policies.

Although the Constitution does not distinguish between the economic stabilisation, income distribution and resource allocation functions of government, the Commonwealth has assumed primary responsibility for the first two while the States retain a large measure of control over resource allocation decisions within the public sector. While the Commonwealth and the States both exercise important regulatory functions (again depending on whether activities are international/interstate or intrastate), the States and their local governments undertake most of the final expenditure by the public sector on goods and services. The Commonwealth's budget is to a large extent a redistributive mechanism or clearing house for making financial transfers between and within the private and public sectors. Some 80 per cent of total Commonwealth outlays consist of transfer payments to persons or families, and payments to State or local governments.

The Commonwealth has explicit constitutional responsibility for the provision of cash social service benefits. This, combined with its involvement through grants to the States, means that the Commonwealth shares responsibility for social welfare with the States, which have the task of organising the direct provision of education, health, housing and other social services.

The Commonwealth and the States both operate business undertakings in fields such as banking, transport, electricity and gas, and water supply. The Commonwealth has constitutional responsibility for postal and telecommunication services.

TAXATION

Customs and excise duties provided more than three-quarters of colonial tax revenues at the time of federation. Although these duties then became exclusive to the Commonwealth, the Constitution required at least three-quarters of the revenues derived from them to be paid to the States during the first ten years of Federation. However, first the States and then, during World War I, the Commonwealth began to exploit personal and company income taxes on a significant scale. The aggregate amount of Commonwealth and State income taxes still did not exceed the revenue from customs and excise duties at the commencement of World War 11, but by then the States were collecting nearly three-quarters of all income taxes. Attempts to co-ordinate income tax arrangements during the 1920s, including a proposal by the Commonwealth that it should withdraw altogether from personal income taxes in exchange for the abolition of its general revenue grants to the States and the retention of its right to levy company taxes, had failed, except for the introduction of joint collection arrangements in 1923.

In 1942 the Commonwealth, faced with the problem of financing a massive war effort from an income tax base which could not be fully exploited because of widely differing State rates, introduced uniform tax legislation which gave it a monopoly over all income taxes. It did this by imposing rates which were as high as to preclude the continuation of State income taxes, and at the same time providing for tax reimbursement grants to be paid to the States so long as they

refrained from levying their own income taxes.

As part of new tax sharing arrangements introduced in 1976 (which are discussed below in the section on grants), the Commonwealth made provision for State personal income tax subcharges to be collected by the Commonwealth on behalf of the States or for State rebates to be granted at their expense, on the basis of a continuation of uniform assessment and collection. So far no State has taken advantage of this provision.

The other factor which has played a decisive role in the distribution of taxing powers has been a series of decisions by the High Court, which have had the effect of excluding the States from sales taxes on goods on the grounds that they are excise duties, which under the Constitution are exclusive to the Commonwealth.

The result has been that the States have been denied access to the most important direct and indirect revenue sources available to states or provinces in other federations. The Australian tax system has become one of the most highly centralised in the world, with the Commonwealth collecting some 80 per cent of all taxes and the States only about 16 per cent (the remaining 4 per cent representing local taxes). There has also been a vertical separation of taxes as between the Commonwealth and State/local taxes, as well as a revenue gap with neither level of government imposing a broad-based consumption tax or, since their abolition during the 1970s, death duties. Likewise, there are no general taxes on capital or capital accretion at either the Commonwealth or State level. Only recently has the Commonwealth begun to tax capital gains on a systematic basis.

The principal Commonwealth taxes are thus individuals and company taxes (which provide more than two-thirds of total Commonwealth tax revenue), customs and excise duties, and a selective and differentiated wholesale sales tax. The principal State taxes are pay-roll tax (transferred by the Commonwealth in 1971 to alleviate the fiscal imbalance between the two levels of government), stamp duties, motor taxes, business franchise taxes, liquor taxes, gambling taxes, levies on statutory corporations and land tax.

GRANTS ARRANGEMENTS

Commonwealth-State grants may take the form of either general purpose or specific purpose grants. Both may include grants for recurrent as well as capital purposes, both may have conditions attached to them and both may include fiscal equalisation provisions.

General purpose grants

Although the Commonwealth was required to share its customs and excise revenues with the States during the first ten years of Federation, the initial general purpose grants strictly defined commenced in 1910-11 and took the form of equal per capita payments (of $2.50) to all States. These continued until 1926-27, after which they were replaced by specific purpose grants in the form of debt charges assistance as part of a general financial adjustment under the Financial Agreement.

The principal general purpose grants in Australia during recent years have been those which resulted from the uniform income tax arrangements referred to in the previous section. The tax reimbursement grants which commenced in 1942-43 were succeeded by financial assistance in 1959-60, whereby the aggregate level of grants was increased each year in accordance with a formula that had regard to changes in population and wage rates and a so-called betterment (or real growth) factor. In 1976-77, the financial assistance grants were replaced by what were called, first, tax sharing entitlements and, later, tax sharing grants, the aggregate level of which depended, subject to varying guarantee provisions, on Commonwealth personal income tax collections and, later, Commonwealth total tax collections. In 1985-86, however, the Commonwealth's principal general purpose grants to the States again came to be called financial

assistance grants, with provision for escalating them each year in such a way as to achieve Commonwealth-designated changes in real terms.

The basis of a distribution of the foregoing general purpose grants is considered below. Since 1970-71, the Commonwealth has also been making general purpose capital grants to the States; these also are discussed below.

Specific purpose grants

The first important specific purpose grants from the Commonwealth to the States, which were for roads, commenced in 1923. As noted above, these were followed from 1927-28 by debt charges assistance under the Financial Agreement. After World War II the Commonwealth began to make grants for such purposes as universities, tuberculosis and mental hospitals, railways and economic development. Advances were also made for housing at subsidised interest rates.

The 1960s and early 1970s were years of acute financial crisis for State governments. Ever since the introduction of uniform taxation, they had been squeezed between the opposing forces of inadequate revenue sources and growing costs of education, health, transport and other services for which they were responsible. In addition to their attempts to have the financial assistance grants increased, therefore, they also actively sought specific purpose grants or accepted assistance when offered. The scope and size of specific purpose programs increased steadily throughout this period. In the years from 1972-73 to 1975-76, specific purpose payments to State and local governments more than quadrupled in money terms, growing from one-quarter to total payments to nearly half.

Existing programs were continued and many new programs were commenced, commissions and other statutory bodies being used to advise on the needs of tertiary education institutions, schools, children's services, hospitals and health services, social welfare, the national heritage, cities and roads. The Commonwealth Grants Commission was given the task of advising on financial assistance for local government. The Commonwealth also assumed full financial responsibility for higher education and took over some State railway systems.

The rapid growth in specific purpose payments eased the States' financial problems and made it easier for them to finance the burgeoning costs of education, health and the other services for which they were responsible, while paradoxically placing the Commonwealth's own budget under increasing strain. There were continuing disputes between the two levels of government about the planning and administration of programs, as well as serious weaknesses in the Constitution. The operation of the advisory commissions also caused problems including defining their relationship to the Commonwealth Government and Parliament, duplication of their activities with those of Commonwealth and State departments, failure to integrate their recommendations in the normal budget processes, virtual freedom from financial constraints and arbitrary methods of distributing the funds among the States. They did not operate as intergovernmental co-ordinating agencies, even though they were advising on financial assistance to States for purposes which were State constitutional responsibilities.

Within a few years after their establishment, most of the specific purpose commissions were abolished or absorbed into Commonwealth departments, leaving only the Commonwealth Tertiary Education Commission and the Commonwealth Schools Commission with major advisory responsibilities in relation to specific purpose grants. They were now required to operate within designated Commonwealth policies and budgetary guidelines, so that they were concerned chiefly with advising on the relative needs of the educational institutions for which the Commonwealth's financial assistance was being provided.

After 1975, many specific purpose programs were abandoned or run down (especially those related to urban affairs, social welfare, housing and transport), while some of the major health programs were consolidated into block grants which the Commonwealth has announced will be

absorbed into financial assistance grants after 1988. The education grants were roughly maintained in real terms, and during recent years there has been a resurgence of specific purpose payments for social welfare, housing and roads so that the aggregate level of this form of assistance remains high. The States continue to have little influence over the form, administrative procedures and conditions attaching to specific purpose programs. However, the lack of stringent revenue conditions has meant that they have generally been able to substitute grants for their own revenue raising, giving them greater revenue flexibility and not significantly impeding their own determination of budget priorities. Even when health grants are excluded, specific purpose payments continue to account for about two-fifths of all Commonwealth payments to the States.

Equalisation grants

What came to be called special grants were paid to financially weaker States, commencing in 1910-11 for Western Australia and being extended to Tasmania and South Australia in 1912-13 and 1929-30 respectively. Initially the claims for specific grants were based on disabilities associated with federal tariff, maritime, arbitration and other policies, but the grants tended to be arbitrarily determined on the basis of political decisions or following ad hoc parliamentary or other inquiries.

Secession movements developed in the three States during the early 1930s as a consequence of disaffection with the effects of Federation. In Western Australia, a secession referendum which had the support of the State Government was passed with a two-thirds majority in 1933. There was, however, no provision in the Commonwealth Constitution for secession by a State and the British Parliament declined to take any action in response to a Western Australian petition. A month after the referendum, the Commonwealth Parliament established the Commonwealth Grants Commission to inquire into and report on applications by the States for special financial assistance.

In its Third Report in 1936, the Commission decided that the financial need of a State, and not any disabilities it suffered as a result of Federation or Commonwealth policies, should be the principle used to determine whether or not a State should receive a special grant. In accordance with this principle and following annual reviews, special grants were paid to the three financially weaker States on the recommendation of the Commission; the Commission's recommendations with respect to special grants were always accepted by the Commonwealth Government.

The principle of financial need was subsequently modified until eventually the special grants became fiscal capacity equalisation grants, defined as the amounts considered necessary to enable the States seeking assistance (so-called claimant States) to provide comparable services to those being provided by the standard States (eventually New South Wales and Victoria, the States with the highest fiscal capacity), subject to them also imposing taxes and charges at comparable levels. The claimant States remained free to determine the levels and pattern of revenue raising and expenditure in accordance with their own policies, so that the special grants had the effect of reconciling equality with the diversity and decentralised decision making which are the distinguishing characteristics of a federal system.

The introduction of uniform income taxation in 1942 complicated the task of assessing special grants, since it now became necessary for the Commission to take into account the distribution of the tax reimbursement grants (later financial assistance grants) among the States as well as its assessments of the revenue and expenditure needs of the claimant States. Except for a brief period towards the end of the 1950s, when those grants were distributed on a basis very close to equal per capita, the distribution came to reflect ad hoc political decisions and it became possible for the three financially weaker States to receive such favourable shares of the financial assistance grants as to make them ineligible for special grants. At varying times after 1959, South Australia, Western Australia and Tasmania ceased applying for and receiving special grants, although South Australia subsequently became a claimant State again between 1970 and

1974 and Queensland applied for and received special grants from 1971 to 1982, when all States agreed not to apply for special grants following reviews of the tax sharing relativities of all States by the Grants Commission.

The first review of tax sharing relativities, which was undertaken as part of the tax sharing arrangements which commenced in 1976, was completed in 1981. The Grants Commission was required to apply the fiscal equalisation principle. For this purpose, it developed a model which would distribute the total funds being provided to the States on the basis of equal per capita shares adjusted for differences in the costs of providing standard services, difference in the capacities to raise revenues from the application of a standard revenue effort, and differences in the per capita amounts of relevant specific purpose grants.

The Commission's assessments implied that, to achieve fiscal equalisation, there should be significant shifts away from the existing distribution of the tax sharing grants to the advantage of the three most populous States - New South Wales, Victoria and Queensland - and to the disadvantage of the other three States. Only marginal changes to the distribution were made following the 1981 review and a further review by the Commission that was completed in 1982, but after another review completed in 1985 State relativities were changed in line with the Commission's assessments so that State financial assistance grants are now being distributed on a fiscal equalisation basis. Another triennial review by the Commission commenced in 1986 for report by 1988.

The present arrangements for distributing financial assistance grants preclude State applications for special grants, but the Northern Territory continues to be eligible for such grants until 1988, after which it will be brought fully into the State financial assistance grants arrangements. In 1986 the Commonwealth asked the Grants Commission to report on whether the amounts of financial assistance received by the Territory in 1983-84 and 1984-85 exceeded the amounts necessary to provide standard services at standard rates of revenue raising.

Among its other tasks, the Grants Commission has also reviewed the finances of the Australian Capital Territory by reference to fiscal equalisation principles, reporting first in 1984 and again in 1986.

PUBLIC SECTOR BORROWING

The Australian Constitution made provision for the Commonwealth to take over State debts existing at the time of Federation, and this was extended by the Constitutional amendment in 1910 to permit the takeover of all State debts and not merely those which existed in 1901.

During the 1920s, arrangements were made to co-ordinate public sector borrowing through the establishment of an informal Loan Council, but the Commonwealth remained unwilling to accept responsibility for State debts as long as the States were free to determine their own borrowing policies independently. Arguments about the assignment of income tax powers between the two levels of government, and about the continuation of the $2.50 per capita grants which the Commonwealth had been making as general revenue payments to the States since 1910, eventually coalesced with the arguments about debt management and borrowing arrangements and resulted in the Financial Agreement of 1927. This provided for: the establishment of the Australian Loan Council as the body formally responsible for Commonwealth and State borrowing; the takeover of State debts by the Commonwealth while leaving the States with the obligations to indemnify the Commonwealth for interest and sinking fund payments on those debts and on all future borrowing now to be undertaken by the Commonwealth on their behalf; and the replacement of the per capita grants by debt charges assistance to be linked with sinking fund arrangements. Following Constitutional amendment in 1928, these provisions of the Financial Agreement became formally embodied in the Constitution.

Following a so-called Gentleman's Agreement in 1936, the Loan Council's control was extended to local and semi-government authorities, so that henceforth all public sector borrowing, other than borrowing for defence or for temporary purposes, came under its jurisdiction.

During the Great Depression the Loan Council and its alter ego, the Premier's Conference, played a decisive role in the determination of economic and fiscal policy, with the States exercising control jointly with the Commonwealth. After the introduction of uniform taxation in 1942, however, the Commonwealth came to dominate the Council and henceforth decisions about the amounts and conditions of public sector borrowing, like other key elements of fiscal policy, were effectively made by the Commonwealth Government. The Commonwealth achieved this domination by a combination of its income tax monopoly, its control over the Reserve Bank, its use of the grants power and its underwriting of State loan programs through so-called special loans. These were provided to the States, on the same terms as public loans, to make up any shortfall in public loan raising in respect of approved programs. The price for the States was that the amounts and terms of all loan raising - not only by State governments but also by their semi-government and local authorities - were now determined by the Commonwealth, and the States increasingly became indebted to the Commonwealth as special loans proved to be necessary in nearly every year between the early 1950s and the early 1970s.

There were some adjustments to the borrowing and debt arrangements in the early 1970s, involving, first, the progressive takeover by the Commonwealth of $1,000 million of State debts and the charges thereon and, second, the substitution of capital grants by the Commonwealth for approximately one-third of the approved State Loan Council programs. The Commonwealth also began to pass the State programs through its own budget, providing itself with an incentive to impose tight restraints on the size of the programs as it began to incur large deficits of its own in the second half of the 1970s and the 1980s. Over a ten-year period the real value of the State Loan Council programs was halved.

During the same period, however, there was a relaxation of controls over State semi-government and local borrowing, involving a series of decisions by the Loan Council designed mainly to facilitate the financing of resource development. These included: so-called infrastructure financing, whereby loans for individual development projects were approved between 1978 and 1981; the freeing of electricity authority borrowing from Loan Council control from 1982; and the progressive deregulation of borrowing by other authorities - as to both amounts and terms and conditions - from 1983. From 1982, also, States were permitted to establish central borrowing authorities to co-ordinate and consolidate borrowing by their authorities.

The States had been responding to the restrictions on their own Loan Council programs by resorting to a wide range of non-conventional forms of borrowing. These included: security deposit arrangements, whereby State governments required private companies involved in resource development to finance public sector infrastructure such as railway and port construction; leasing arrangements; commercial buyer or supplier credit; deferred payments; instalment purchasing; and export credits. As a result borrowing outside approved Loan Council programs accounted for about 60 per cent of total net borrowing by 1983-84. In order to restore Loan Council oversight over authority borrowing, the Gentlemen's Agreement was suspended in 1984 in favour of a so-called global approach, whereby the Commonwealth and State Governments agreed to voluntarily limit authority borrowing from all sources to global limits agreed by the Council. In 1985 the Gentlemen's Agreement was formally terminated, so that the global approach now forms the basis of the Loan Council's oversight of authority borrowings, albeit with the States exercising a greater influence over the decisions taken. Interest rates and other terms and conditions are now left to individual governments and the market to determine.

CONCLUSION

It is possible to identify three phases in the development of Australian Commonwealth - State

financial arrangements, involving what maybe called co-ordinate or decentralised federalism, co-operative federalism and centralised federalism respectively.

The first period, from 1901 to the 1920s, saw the Commonwealth and the States carrying out their fiscal responsibilities largely independently of each other, in accordance with the powers assigned severally to them by the Constitution.

The period of co-operative federalism, which commenced during the 1920s and ended in 1942, was marked by the establishment of the Australian Loan Council and the Commonwealth Grants Commission, the sharing of fiscal responsibilities during the Great Depression of the 1930s and the establishment of the first Commonwealth-State ministerial councils, such as the Australian Agricultural Council, to co-ordinate policies in fields of common interest.

Centralised federalism commenced in 1942 with the uniform tax legislation and has been distinguished by Commonwealth domination over the Loan Council, constitutional amendments and judicial decisions which have had the effect of extending Commonwealth powers, the consolidation of a highly centralised taxation system, the substitution of Commonwealth general purpose grants for State income taxes, and the use of specific purpose grants on a massive scale to facilitate Commonwealth involvement in expenditure responsibilities for which the States are formally responsible under the Constitution.

At the time of Australia's bicentenary, there are some signs that some of these centralising tendencies may be relaxed or even reversed. The States have regained a degree of influence in the Loan Council within what is now a largely deregulated system of loan raising; they have access to income taxes if they choose to levy surcharges; the scale of Commonwealth general purpose and specific purpose grants during recent years has, paradoxically, substantially strengthened their fiscal positions at the expense of the Commonwealth; the recent work of the Commonwealth Grants Commission has resulted in a large measure of horizontal fiscal equalisation; and there has been a diminution in the importance of specific purpose grants relative to other funds available to the States. But the main impetus towards decentralising tendencies in Australia's federal financial arrangements is likely to come from the developing weakness in the Commonwealth's own budgetary position, as it endeavours to grapple with large deficits, contain the growth of government expenditures and reform the taxation system.

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